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Conditional vs. Unconditional Grants: The Case of Developing Countries

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General Grants versus Earmarked Grants Theory and Practice The Copenhagen Workshop 2009

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Photo: Photo of Højbro Square (Højbro Plads) on the book cover: The Højbro Square is a rectangular public square located between the adjoining Amagertorv and Slotsholmen Canal in the city centre of Copenhagen, Denmark. The most striking feature of the square is an equestrian statue of Absalon, Danish archbishop and statesman, who was Bishop of Roskilde from 1158 to 1192 and Archbishop of Lund from 1178 until his death in 1201. Due to the popular view Absalon was the founder of the City of Copenhagen.

Photo of Rentekammer Hall (Rentekammersalen) on the back of the book cover: With its almost 100 square meters, the Rentekammer Hall is the largest hall in the Danish Ministry of Finance. The hall is dominated by a stucco ceiling featuring a large painting by Hinrich Krock (1671-1738). Krock was inspired to paint the scene while studying in Italy.

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Chapter 4

Conditional vs. unconditional grants: The case of developing countries

Roy Bahl

4.1. Introduction

Because subnational government taxation is not a viable option in many low-income countries, the financing of decentralized services often comes down to the choice between an unrestricted grant and one with conditions laid down by the higher level government. The central policy question that arises, and is explored in this paper, is how this choice does or does not compromise the success of fiscal decentralization.

We begin with some definitional issues and with empirical evidence about the revenue dependence on transfers in low income vs. OECD countries. Then we discuss the theoretical and practical advantage of conditional grants vs. unconditional grants in developing countries and give an illustrative review of the practice⁴⁵.

4.2. Definition and measurement

The term “transfer” refers to the case when money is raised at a higher level of government and passed to the lower level by some formula or ad hoc approach. We distinguish transfers from local taxes. The latter refer to the case where the subnational government is empowered to at least set the tax rate, and thereby has power at the margin to determine its revenue budget.

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There are a number of different kinds of public financing instruments in the transfer category: “grants”, “shared taxes”, “subsidies”, and “subventions” are but a few. Some of these are designed to be centralizing in nature because they allow for control of the use of these funds by the higher level government, while others are decentralizing in that they pass significant discretion to subnational governments. Intergovernmental fiscal systems in developing and transition countries are more centralizing than those in industrial countries. On the financing side, this centralization is accomplished by giving little taxing power to the local governments, and on the expenditure side it is done with mandates and conditions in the grant system.

4.3. Revenue importance

The importance of transfers in national financing systems might be evaluated in several different ways. First, we may note that transfers average about 6 percent of GDP in transition countries, compared with only about 2 to 3 percent in developing and industrialized economies (Table 1). Because of their higher level of economic development, many industrial countries have been able to adopt a more decentralized approach to governance (Bahl and Wallace, 2005). That transfers are a greater share of GDP in transition economies is not a reflection of their decentralized expenditure approach but their general unwillingness to decentralize revenue raising powers. In general, the share of transfers in GDP will be larger if the overall level of government revenue mobilization is greater and if lower level governments are relied on more heavily for service delivery and smaller if subnational governments are given more taxing powers.

Another way to make comparisons of the revenue importance of intergovernmental transfers, and one that is independent of the overall level of revenue mobilization, is to consider the share of the central government budget that is allocated to transfers. As may be seen from Table 1,

Table 1. The revenue importance of intergovernmental transfers

	As a percentage of GDP	As a percentage of central government expenditures	As a percentage of subnational government Expenditures
Developing countries (33) ^a	2.18	11.52	59.47
Transition countries (15)	6.42	15.80	44.09
Industrialized countries (24)	2.78	27.13	50.30

Source: International Monetary Fund (various years), *Government Finance Statistics Yearbook*; International Monetary Fund.

^a Number of countries compared is shown in parentheses.

the industrialized countries allocate about twice as large a share of their central government budgets to intergovernmental transfers as do either developing or transition countries. Again, this reflects the much greater commitment to fiscal decentralization in the OECD countries.

Finally, we might compare the importance of transfers by noting that subnational governments in developing countries are more dependent on transfers than are subnational governments in industrialized countries (Table 1). It will surprise few who study these matters to see that transfers finance nearly 60 percent of subnational government expenditures in developing countries, though in fact it might surprise some that this share is not larger. The share is smaller in the industrialized countries because they have devolved more revenue-raising authority to their subnational governments⁴⁶

4.4. Conditionality and the objectives of transfer systems

Higher-level governments make use of intergovernmental transfers

⁴⁶ Note, however, that there is a very great disparity between federal and unitary countries in this regard. For a discussion of tax assignment in industrial countries see Bahl (2009).

for good economic reasons, and for understandable political reasons. The role of conditionality in a transfer system is bound up with this economic and political rationale. The first principles of fiscal federalism, where this rationale is laid out, are by now well developed and have been taught to several generations of students of public finance (Musgrave 1983, Bahl and Linn, 1992; Bird and Ebel, 2007). But while these principles provide good general guidance for industrialized countries, some important amendments are needed to take account of the economic setting and the particular institutional arrangements that often characterize low-income and transition countries.

The theory behind the use of conditional grants is straightforward, but implementation raises a number of issues. The problem lies mostly in the design and management of the grant system. There is almost always a disconnect between the goals the government has for an intergovernmental transfer, the design of the transfer instrument, and the implementation. Sometimes the disconnect between them is so great that the objectives of the transfer are not realized.

4.5. Vertical balance

Arguably, the principal reason for intergovernmental transfers in LDCs is to redress the imbalance between the expenditure responsibilities of subnational governments and their revenue raising powers. While economic development has led to growth in the expenditure budgets of provincial and local governments, it has not led to a decentralization of taxing powers. The result in developing countries is almost always an inability of subnational governments to finance adequate levels of public services from their own sources (Bahl and Wallace, 2005; Bahl, 2009).

The resulting financing gap (the vertical imbalance) for less developed countries and for transition countries is usually filled by intergovernmental transfers. As countries develop, there is a shift toward asking subnational governments to raise more of their own resources. In the U.S., for example, transfers finance less than one-fourth of all state and local government expenditures, mostly because the state and local governments have access to a wide variety of consumption and income taxes. The same is true in most

OECD countries where there is extensive use of subnational government income taxes. Denmark, Spain and Switzerland are cases in point. Among developing and transition countries, however, most have not reached a threshold of comfort with subnational government taxes. Subnational government taxes in OECD countries are about five times higher than in low income countries even after adjustment for GDP. There are notable exceptions, of course, such as Argentina and Brazil (Rezende and Afonso, 2006; Tommasi, et. al. 2001).

In theory, the vertical gap could be filled by either a conditional or an unconditional grant. Those who advocate fiscal decentralization will prefer an unconditional grant because the funds may be used to either address expenditure needs in general or to lower taxes. In the case of a conditional grant, the focus would be more on closing the gap in particular sectors. The question of which is the best choice will come back to the extent to which the goal is central control of the use of the grant funds vs. addressing local expenditure needs based on local preferences.

4.6. Equalization

Developing and transition countries are characterized by wide inter-regional disparities in economic well-being. It is not unusual for the average income in the richest provinces to be 10 times higher than that in the poorest places. These income disparities are directly reflected in differences in revenue-raising power. To the extent that subnational governments are given more independent revenue raising powers, these disparities will widen because the more urbanized local governments have the greatest taxable capacities and the strongest administrative infrastructures.

Countries do acknowledge the need for equalization of inter-regional differences in fiscal capacity in a decentralized system, and they must rely on intergovernmental transfers to accomplish this. Otherwise, the gap between subnational governments in the quality of public services provided would be out of step with social equity goals, and could be politically unacceptable. The design principles for an equalizing transfer system are simple enough: measure the extent of fiscal disparities, decide how much of the

gap will be eliminated, and develop a formula that will produce the desired equalization. This is easier said than done, apparently, because the implementation of a successful equalizing grant system is a challenge that few developing countries have met.

Most countries design equalization grants as general support programs to reduce disparities in the capacity to finance local services (Hull and Searle, 2007). This approach leaves it to the recipient government to decide whether it will spend the money on pro-poor services or tax reduction.

Conditional grants also are used for equalization purposes, but the grant design is tricky. Much depends on the grant conditions that are laid down. If the restriction is expenditure on a specific (pro-poor) function, and if eligibility is limited to poorer local governments, equalization might be accomplished. If the conditions have to do with matches from local funds, or preparation of acceptable expenditure plans, lower income governments may not be able to buy into the program.

4.7. Externalities

Another rationale for the use of intergovernmental transfers is to stimulate the provision of adequate levels of local public services when externalities are present. Left to make their own decisions, without any incentives or penalties, local governments will underspend (overspend) on services where there are substantial external benefits (costs). This situation is well known in the industrialized countries, and it also holds true in the developing countries. Conditional grants are an instrument that can be used as an incentive to encourage local governments to increase their spending on functions with external benefits.

Central governments sometimes read the externality justification quite broadly to include both the need to take spillover effects into account and to stimulate spending to support national economic development or equity objectives. Sometimes the conditionality may involve earmarking a transfer for a specific purpose. However, it may also involve a local revenue matching condition or a requirement that services be delivered in a particular way. Or, the condition may be more general, as in a required mandate to

limit spending on personnel or to cover only capital activities. The condition may not even be on the expenditure side, for example, the case of a grant that is conditional upon increased revenue mobilization.

The design of an intergovernmental transfer system to address externalities requires policymakers to decide on the size of the grant required. In the case of a subsidy that reduces the unit cost of a particular service, the question is, what is the amount of subsidy required to induce the local government to expand public output to the target level? Government fiscal planners in developing countries mostly guess at what the right level of output might be. In fact, these underlying issues -- the size of the external effect and the price elasticity of demand for the service -- are usually ignored by fiscal planners. More often than not, the size of the grant is determined on the basis of affordability. The resulting expansion in output for the targeted function may or may not achieve efficient levels.

A major drawback of cost reimbursement grants is that the recipient governments may not spend the money for the dedicated purpose. "Money is fungible." If a subnational government receives a grant of \$1000 for primary education, will spending for primary education be \$1000 higher than it would have been in the absence of the grant? Because these transfer funds and other revenues are substitutes, the true impact of a grant may be hidden. Monitoring becomes all but impossible. There is no easy way around the fungibility problem. Higher level governments in developing countries usually try to address this issue by either limiting earmarked grants to functions where the unmet demand is great and there is no sentiment for displacement, by placing a minimum amount of expenditures on the functions in question, or by limiting local expenditures on such items as salary increases, new hires or general administration.

4.8. Administrative justification

Intergovernmental transfers are thought to be a less costly way to finance government because the central government can assess and collect taxes more cheaply than can subnational governments. Another often-made argument is that subnational governments are

more corrupt than the central government, and therefore a shift of responsibility to subnational governments will lead to a waste of revenues. For these reasons, it is more efficient for the central (state) government to collect the taxes and then allocate some portion of the revenues to the lower level of government in the form of transfers.

There are counterarguments against both of these propositions. In fact, all taxes are not more efficiently administered by higher level governments. The property tax, user charges, motor vehicle licenses, and local business licenses are examples. The comparative advantage of subnational governments in all of these areas is their more intimate familiarity with the local tax base and with local taxpayers.

The charge that subnational government tax administrations are more corrupt than central government tax administrations is more accurately stated as a hypothesis. Some researchers have pointed out that corruption may be even greater at the central level because of less transparency and because the amounts involved are so much larger (Martinez-Vazquez, Arze del Granado and Boex, 2007).

The connection to conditional grants here is only indirect. If the real reason for constraining subnational government taxation is to resist local government expenditure autonomy, then the central government is likely to focus on conditional grants so that it can control subnational government budget allocations. An unconditional grant, by contrast, could give lower level governments the same discretion as would an equal amount of local tax revenue.

4.9. Political justifications

Governments also adopt (or reject) intergovernmental transfers for political reasons. These reasons fall into three categories. The first is that the central government is resistant to giving up the control over governance that would come with giving revenue-raising powers to subnational governments, because authority to make decisions about the service delivery financed with these revenues would be passed from central bureaucrats to provincial and local

bureaucrats, and this would significantly dilute the power of the former. An alternative to giving up this power, while not fully rejecting the decentralization initiative, is to provide local governments with intergovernmental transfers that carry stringent conditions.

A second political reason for advocating intergovernmental transfers is the goal of enforcing uniformity in the expenditure mix and the revenue structure chosen. One way to restrain local governments from making fiscal choices is to structure intergovernmental transfers to limit local discretion. Third, a transfer system may be put in place as part of a political strategy to hold open the option of offloading the budget deficit on to subnational governments. The Philippines is an example where this strategy was used for a number of years.

All this said, the politics may also swing back and forth between preferences for fiscal centralization and conditional transfers and for decentralized taxing powers and unconditional grants. This was the case in Russia where the Yeltsin years were a time of advocating more power for the regional governments, whereas the Putin years have seen more pushback toward fiscal centralization. (Martinez-Vazquez, Rider and Wallace, 2008, chapter 7).

4.10. The practice: Conditional vs. unconditional grants

Every intergovernmental transfer has two dimensions: the first is the *vertical share*, the distribution of revenues between the central government and all of the subnational governments. The second is the *horizontal sharing*, the allocation of the total grant fund among the recipient units. The design of a grant system requires deciding on *both* a structure of vertical sharing and a structure of horizontal sharing. There are elements of conditionality in both vertical sharing and horizontal sharing.

This paper expands on an approach developed by Bahl and Linn (1992) to describe and distinguish among the different types of transfers commonly found in developing and transition countries (See Table 2). Clearly this simple two-way classification is an oversimplification, because countries tweak the vertical and horizontal sharing arrangements in many ways. Still, this

description of the architecture is good enough to make the point that different combinations of vertical and horizontal sharing choices can lead to fundamentally different types of intergovernmental transfers.

4.11. The architecture of vertical sharing

As suggested by the columns in Table 2, there are three more or less common approaches to determining the size of the total grant pool (i.e. the vertical dimension). The total to be allocated may be determined as a share of some central or state government revenue source, it may be determined on an ad hoc basis, or it may be determined on a basis of cost reimbursement.

Table 2. Alternative forms of intergovernmental grant programs

	Method of determining the total divisible pool		
Method of allocating the divisible pool among eligible units	Specified share of national or state government tax	Ad hoc decision	Reimbursement of approved expenditures
Origin of collection of the tax	A	n.a.	n.a.
Formula	B	F	I
Total or partial reimbursement of costs	C	G	K
Ad hoc	D	H	J

n.a. Not applicable.

Note: For definitions of forms A-K, see text.

The shared tax. Arguably the form of vertical revenue sharing that is most in step with the goals of fiscal decentralization is the *shared tax* approach (the first column in Table 2). In this case, the central government allocates a share of national collections of some tax (or of all taxes) to the provincial/local government sector. In effect, this gives subnational governments an entitlement to a share of national revenues and makes them partners in the central

tax system. It provides some degree of certainty to the revenue flow to subnational governments, and it could give local governments access to broad-based and income-elastic taxes.

The choice of a shared tax, and the rate of sharing, will depend on the commitment of the central government to fiscal decentralization. Countries that are pushing subnational governments to be important players in the public service delivery system will choose major revenue sources with income-elastic tax bases, or will share collections from all taxes with their local governments. The cornerstone of the Indonesian decentralization program that took effect in 2001 was a 25 percent sharing of all domestic revenues. The Philippines allocates 40 percent of the total internal tax collection (in the third preceding year) to local governments. The proceeds from all central government taxes are assigned to the divisible pool in India, and in 2003, the state government share was 30 percent. In Pakistan, the provincial share is 41.5 percent of central taxes. This approach is not an uncommon choice for many developing and transition countries.

Tax sharing is nearly always distributed in the form of unconditional transfers. The basic idea is to channel more funds to subnational governments and not to provide an incentive to make any adjustment to spending patterns. Central governments that would like to impose stringent conditions on recipient local governments would not usually follow the tax sharing approach to vertical sharing, though there are some exceptions.

Ad hoc transfers. A second approach to vertical sharing is for the central government to decide on a total allocation to the subnational government sector. Whereas the shared tax approach gives subnational governments an ownership of some share of central revenues, the ad hoc approach sends an opposite message: the center owns all of its revenues and may or may not choose to grant some share to the subnational government sector. This approach to determining the vertical share often involves more negotiation and political consideration than subjective analysis of vertical imbalance, and both the approach taken and the amounts agreed upon may vary from year-to-year.

Obviously, there are great drawbacks to such a subjective

determination of the sharing pool. Because it is not transparent, and it is subject to political manipulation, this approach leads to uncertainties on the part of the subnational government sector and impedes fiscal planning and effective budgeting. Rezende and Afonso (2006) report that between 1996 and 2000, the amount of ad hoc transfers to subnational governments for social services in Brazil doubled. The ad hoc approach sends a signal that the central government may treat the subnational government sector as a lower priority use of resources.

In some ways, an ad hoc system of vertical sharing gives the central government more control over local spending than any other approach, because the full program may be terminated (or expanded) at central discretion. Moreover, the national government can change its spending priorities and delivery methods without changing the expenditure assignments of each level of government. Finally, the ad hoc approach allows for a reduction in the subnational government claim on revenues as the situation in the country changes.

In sum, the ad hoc approach to determining the size of the distributable pool is the most centralizing approach to designing an intergovernmental transfer system. It can feature conditional grants, but there is an option to close down funding for a program without concern for an entitlement of subnational governments to a particular amount of funding. This approach is widely used, even in countries such as Brazil that feature decentralization as part of their development plan.

One would expect a centralizing ad hoc approach to vertical sharing to be used in conjunction with conditional grants. In fact, this often is the case. Examples abound of the ad hoc approach to vertical sharing, as is described in Bahl and Wallace, (2007, Table 4). The most common type is a voted annual allocation to conditional grant programs as is done in Tanzania and in Brazil for health and education programs. The Autonomous Region of Muslim Mindanao in the Philippines is funded primarily by an annual ad hoc grant program (Manasan, 2009).

Cost Reimbursement. Under a reimbursement approach, the higher level government defines a service for which it will

guarantee to cover some portion of the cost incurred by subnational governments in delivering that service. The major difference between the reimbursement and the ad hoc approaches are that the former are more established programs that are based on a law and are not regularly redefined. Functions that are often targeted are teachers' salaries, health supplies, highway construction and maintenance, and infrastructure projects. Most developing countries include some form of conditional grant in their transfer system. (Bahl and Wallace, 2007, Table 5).

Once the eligibility and reimbursement rules are established, the vertical share can be determined by simply adding up the entitlements of the eligible units, i.e. the grant could be open-ended. But probably the more common approach is to first determine the vertical share based on affordability, then "cut the cloth" in terms of reimbursement and eligibility. In effect, this makes the grant closed-ended. The cost reimbursement approach is likely to involve a large number of conditional grants that are controlled by the line ministries and are continued from year-to-year. Before 2004, Tanzania's conditional grants were contained in 21 budget votes (Boex and Martinez-Vazquez, 2006). In Australia, about 40 percent of transfers are made up of 90 conditional grants for both current and capital purposes (Hull and Searle, 2007). In India there are more than 50 expenditure heads for conditional grants to rural local governments (Sethi, editor, 2004).

Cost reimbursement grants can take many forms. They may directly cover a percent of cost, e.g. 80 percent of the cost of road construction and maintenance. Or, they may be implicit cost reimbursement, as in the case of a conditional grant for primary education where no specific cost share is stated. In the latter case the tax price for primary education spending is lowered because of the grant.⁴⁷

The great advantage, and disadvantage, of the cost reimbursement approach to vertical sharing is its conditional nature. On the one

⁴⁷ If the grant money is not fungible, then there is no effect on the tax price since the total amount of the grant is additional spending on that function.

hand it allows the higher level government to specify those public service areas where it would like to see increased subnational government expenditures. So long as these transfers are targeted on public functions where there are significant externalities, conditional grants have the potential to be efficiency enhancing. It also allows the granting government to impose certain standards on service delivery and public facility construction, and thereby helps to impose uniformity and minimum standards in the delivery of some services. Conditional grants of this type might be seen as moving the fiscal system part of the way toward decentralization: it gives the subnational governments more discretion than if they were simply spending agents of the center, but it gives the higher level government some control over the use of the funds.

On the other hand, there are also important disadvantages to conditional grants. From the point of view of subnational governments, such grants limit budgetary discretion and can lead to “unwanted” public investments. Examples abound of local governments being unwilling to maintain capital facilities that were heavily financed by central government cost reimbursement grants.

So, central fiscal planners are caught on the horns of an efficiency dilemma. They can stay with the conditional grant and trust that they can guess correctly on the external benefits, or they can give an unconditional grant to subnational governments and then deliver functions with big externalities through vertical programs. As we discuss below, this is perhaps the major policy choice that surrounds the use of conditional grants in developing countries.

Finally, the cost reimbursement approach imposes an administrative cost on the higher level government, which must monitor the program, and a compliance cost on the subnational governments that must do significant reporting on their use of funds and their adherence to standards. It is more cumbersome, and more costly to administer, than is either the shared tax or the ad hoc approach to vertical sharing.

4.12. The architecture of horizontal sharing

The architecture of horizontal sharing

Four methods of horizontal sharing are commonly observed: a derivation approach, a formula approach, a cost reimbursement approach and an ad hoc approach. Following our argument that the impact of a grant system depends on both the vertical and horizontal dimensions of grant design, we note 10 possible options for designing a transfer, as reported in Table 2. Eight of these ten types of transfer could be structured as conditional grants.

The derivation approach A Type A transfer, as shown in Table 2, is the “derivation approach” to revenue sharing. Under this approach, the total grant pool is determined as a share of a national tax, and each subnational government receives an amount based on collections of that tax within their geographic boundaries. For example, 25 percent of value-added tax collections in China are allocated to the subnational government sector, and the allocation is made according to amounts collected inside the boundaries of each regional government. It is important to note that this is an intergovernmental transfer and not a local tax, because the subnational government has no control over the tax rate or the tax base.

The derivation approach is practiced widely among developing and transition countries, and there is much variation in the practice. Derivation-based sharing is a way for subnational governments with a stronger economic base to gain access to the more productive central taxes. In this regard, it might be thought of as an approach that is friendly to the economic development goals of decentralization. VAT, company income taxes, individual income taxes, and some of the productive excises are included in the sharing base in various countries. In other cases, the taxes shared on a derivation basis are more narrow-based and less productive. It would be hard to say that there is a “common” practice.

This approach to distributing intergovernmental transfers has some features that can be seen as positive or negative, depending on where one sits. First, derivation-based shared taxes are counterequalizing because the richer regions have the stronger tax bases and probably the strongest administrative machinery for

collection. The result is that, *cet. par.*, the disparities in taxable capacity between rich and poor regions will be widened under a program of derivation – based tax sharing. For example, Zhang and Martinez (2006) point out that 9 of China's 28 provinces collect 70 percent of income taxes.

Second, derivation-based transfers usually are unconditional and carry relatively few strings. Subnational governments do not get much choice about the level of revenue they receive, but they do have freedom in deciding on the expenditure of this money (unless expenditure mandates are also present in the intergovernmental financing system). On balance, derivation-based shared taxes probably lead to more accountability to local voters for the quality of local government expenditures than do conditional grants.

Third, derivation-based shared taxes might stimulate some increase in subnational government tax effort, because there is a link between the amount of tax collection in the local area and revenue accruing to the local government. The basic issue here is whether the subnational government has some discretion to affect the level of tax collections.

Fourth, derivation-based sharing should produce more certainty in local budgeting and fiscal planning than would most other forms of intergovernmental transfer. Subnational governments are in a position to forecast, with some accuracy, the year to year movements in revenue, and unless the central government changes the sharing rates, this enables a proper budget planning process to take place.

The administrative costs associated with derivation-based sharing are low relative to most other forms of transfer. Moreover, there usually are not significant compliance costs imposed on the subnational governments, because there are few strings attached. Nor does the central government need to monitor the use of the funds by the local government.

Formula grants A second common approach to the allocation of intergovernmental transfers among local governments is the formula grant. A formula grant uses some objective, quantitative criteria to allocate the pool of revenues among the eligible

subnational government units. The most common reason why governments move to a formulae-based distribution is to gain transparency in the distribution of grants. This creates a sense of fairness in that all know the exact criteria by which distributions are made. In short, formulas are meant to limit the higher level government's discretion in deciding how much revenue will be allocated to each local government unit.

Three types of formula grants are described in the schemes in Table 2: B, F, and I type grants. The *Type B* formula grants could be the most in step with the goals of decentralization, if the vertical shares are adequate in size and tied to growing tax bases. This would give subnational governments a dedicated claim on central revenues for an unconditional grant. Indonesia, the Philippines and Pakistan are examples of countries that adopted this form of revenue sharing, and in all three countries the base for sharing is total tax revenues. The transfers in these cases and under most similar systems are unconditional.

The other two types of formula grants are more limiting to subnational government discretion. *Type F* grants (ad hoc vertical sharing) give the higher level government maximum discretion in setting a high or low vertical share and determining whether the grant will be conditional or unconditional. *Type I* formula grants will be conditional and are likely to reflect central government priorities and standards for local public services. Certain social service grants in Latin America are structural in this fashion (Diaz-Cayeros, Gonzales, and Rojas (2006).

4.13. Cost reimbursement - conditional grants

Arguably the most common form of conditional grant is a cost reimbursement grant (*Type C, G, K*). Irrespective of the way that the vertical sharing is arranged, these grants imply some action by the subnational government as a condition of receiving the funding. In most cases, they are structured to reduce the cost of providing a particular service, though there are other forms of conditions as well.

A Type C grant would fix the vertical share as an entitlement, based on a share of national tax collections, and then specify the

use of the grant money. For example, in some Latin American countries, a specified share of natural resource taxes are shared with subnational governments but distributed on a conditional basis (World Bank, 2005). The vertical share for earmarked education grants in Argentina is a fixed percentage of national taxes, and distribution is made by subnational government payrolls in the education sector. The major advantage of this approach is the strong guarantee that the grant money will flow and that it will grow with the economy.

The K-type conditional grant (entitlement programs) may be protected by statute in terms of the vertical share, whereas the G-type conditional grants (ad hoc vertical sharing) rely on an annual allocation from the budget. In both cases, however, these can be thought of as sectoral ministry programs in terms of the objectives, conditionalities and monitoring.

The horizontal sharing arrangement for conditional grants typically has three features. First, the higher level government specifies the functions on which the money will be spent, i.e. the grants are conditional. Hence the local tax price associated with delivering that function is lowered vs. a situation where there is no grant support. Second, the degree of cost sharing may be specified, i.e. the grant may carry a matching requirement. Third, standards of performance, construction, employee qualifications, etc., may be part of the conditionality in these grants.

Conditional grants raise two more general problems. First, they can impose quite large compliance costs on recipients in the form of reporting on the disposition of the funds. At its simplest level, this might involve no more than reporting that the grant money was spent under certain budget heads. At its more difficult level, compliance may require reporting and verifying that expenditures were made on specific budget subheads, certifying that expenditures were made only on eligible projects within the local government area, providing information on contractual arrangements, etc.

Second, conditional grants can be problematic if they are not coordinated. Most conditional grants are the responsibility of a particular sectoral ministry, and in many cases there is insufficient

communication across ministries. Sometimes, regional and local (elected and or appointed) bodies are formally established to plan and coordinate, but the success record here is variable.

The use of conditional cost reimbursement grants, and their rate of success in achieving their objectives, varies widely around the world. Countries seem to tailor their conditional grants to control subnational government spending patterns in a way that satisfies national priorities and political objectives. There is also some evidence of regional copycat patterns.

In Latin America, many countries dedicate a portion of national taxes to specific expenditure categories. More recently, there are calls in many of the countries to loosen the conditions so that subnational governments can have more discretion to meet particular local needs. Among the industrial countries, Japan uses a system where national disbursements are earmarked for a number of specific expenditure categories.

Some conditional grants are designed with numerous conditions, over and above earmarking, to assure the achievement of specific objectives. India's rural employment program has the twin goals of providing wages to the rural poor and implementing public infrastructure projects in these areas. The grants are matching, earmarked for this program, and the services are delivered by rural local governments. However, there are some stringent conditions, such as the eligibility requirements for workers and the prohibitions against using contractors and capital equipment.

4.14. Ad hoc distributions

The horizontal sharing of the total grant pool for conditional grants may be ad hoc (*Types H, J*). That is, each year the higher level government will decide how it will distribute grants among eligible local governments. This is not an uncommon method for allocating capital grants among local governments. The most centralizing version of this form of grant is when both the grant pool and the distribution are determined on an ad hoc basis. A popular method of making ad hoc allocations is for subnational governments to "request" projects and for the higher level government to choose those that will be funded. This is a variant on the cost

reimbursement approach. Whereas conditional grants distributed under a reimbursement approach tend to be programmatic and have defined entitlements, those distributed under an ad hoc approach do not. Under a reimbursement program, parliament would appropriate a pool of funds to be spent on specified projects, but would distribute the funds on some subjective basis or would direct that the line ministries do so.

By almost all standards of a “good” intergovernmental transfer, ad hoc grants fail. They are not transparent, compromise local fiscal planning because they fluctuate significantly from year to year, and probably would not be driven by clearly stated objectives such as revenue mobilization or equalization.

One can point to some advantages of ad hoc transfers. From a point of view of the central government, these grants are “controllable” and are flexible enough to reflect the changing priorities of the center. They might also allow the government to move through a transition period from one grant system to another without disrupting service delivery. Moreover, they might be structured to impose little administrative costs, i.e. no formulae, no conditions, etc.

There are many examples of the use of ad hoc methods of distribution, though no two approaches seem to be the same. In Brazil, social contribution grants are distributed among subnational governments by ad hoc negotiations, but conditions are attached to the use of these funds (Rezende and Afonso, 2006). All annual grants to local governments in Thailand are distributed on an ad hoc basis (Weist, 2003). Both current and capital grants are distributed on an ad hoc basis in Nigeria (1999). Ad hoc grant programs tend to be popular in smaller countries where the central government feels that it has a good sense of needs at the local level or where data to support a formula approach are not available. Jordan and Malawi are examples.

4.15. Conclusions and summary

Conditional vs. unconditional grants from higher to lower level governments is a choice that is driven by a nation’s vision about its governance. The more the vision includes subnational

governments as being responsible for delivery of basic services, and for the allocation of public financing activities, the more the choice will tilt toward local government taxation or unconditional grants as financing instruments.

The case of developing countries is different, and the conditional/unconditional grant choice is arguably more difficult than in the industrial countries. Administrative constraints of subnational governments in low-income countries limit the possibilities for general taxation and raise questions about the service delivery capabilities of these subnational governments. Moreover, there are macroeconomic considerations, i.e. central government misgivings about increased revenue mobilization powers at the local level and a fear that subnational governments would direct expenditures away from high priority national goals. By comparison with most of the OECD member countries, developing countries have an unfinished public infrastructure, a low rate of revenue mobilization, and a high level of inter-regional fiscal disparities. The problems of designing an intergovernmental transfer system are qualitatively different.

There is no comprehensive survey available to help identify an international trend toward one or another form of transfer. Moreover, “conditional” and “unconditional” grants are general terms that refer to a variety of different approaches to intergovernmental transfers. The vertical and horizontal arrangements that are used to share central revenues result in a number of grant types with different impacts. This makes it very difficult to generalize about the advantages and disadvantages of conditional vs. unconditional grants.

Many countries have adopted revenue sharing arrangements that feature unconditional transfers where the subnational governments have discretion over how the funds will be spent. These systems feature an entitlement to a share of national tax collections and often are distributed on a formula basis.

At the other extreme are various forms of conditional grants with earmarks and matching provisions laid down at the central level. In some cases, the conditional grants give the subnational governments an entitlement in terms of both guaranteed funding

and a formula distribution. In other cases the funding and the distribution among recipients is ad hoc.

The conditionality provisions vary greatly across countries. In some cases, it is a cost recovery and earmarked for a particular function. In other cases the restrictions that go with the grant are detailed and involve significant compliance costs. Central governments argue that the conditions are necessary to ensure efficient expenditure of the funds, but subnational governments often see it as a harmful encroachment on local autonomy and a challenge to the objective of fiscal decentralization.

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